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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1944

No. 371

COMMISSIONER OF INTERNAL REVENUE,
*Petitioner,*

*against*

JOHN H. SMITH,
*Respondent.*

## MEMORANDUM OF AMICI CURIAE IN SUPPORT OF PETITION FOR REHEARING

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March 20, 1945.

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## MEMORANDUM OF AMICI CURIAE IN SUPPORT OF PETITION FOR REHEARING

This memorandum is filed because of the far-reaching effects and implications of this Court's opinion (delivered by the Chief Justice on February 26, 1945) beyond the confines of its particular facts, and especially because of a fundamental misunderstanding of those particular facts. It is submitted that this Court should grant the petition for rehearing and set a date for reargument.

### Grounds for Rehearing.

The reasons for our submission are two-fold:

1. *This Court in its opinion inadvertently stated material facts in a manner at variance with the findings of the Tax Court. Such facts have an important bearing upon the decision.*

(a) The Tax Court found that the option was exercised in its entirety, and all the stock paid for, in March, 1938, at a time when the fair market value of the stock was $2.50 a share (R. 27, 29, 19, 20). This Court inadvertently states that the option was exercised and the stock was paid for partly in 1938 and partly in 1939. In 1939 the fair market value of the stock averaged about $5.90 per share. This Court states in its opinion that the compensation was "derived from exercise of the option" and was measured by the value of the stock over the option price "whenever the option was exercised". On that theory, the compensation could not exceed the excess of $2.50 per share over the option price.

(b) The Tax Court found that the option itself was given as compensation for services (R. 24, 33). The Tax Court did not find (as assumed by this Court) that the option was worthless or had no fair market value when received by the employee. There was testimony that the value of the option was small, but none that it was worthless. The Tax Court failed to make any finding on that material question. A long-term option (in this case running for over five years) to purchase stock at more than the market value of that stock when the option is given does have value, as is shown by the quotations for such options contained in Appendix A hereto. This case should be remanded to the Tax Court for a finding as to the value of the option on the date of its receipt.

2. *This Court should further clarify the effect of its decision in this case upon its decision in Palmer* v. *Commissioner, 302 U. S. 63, which has been generally regarded as*

*holding that the receipt of an option granted at or above the current market price cannot result in the realization of income.*

In the *Palmer* case, this Court said that options are at most "continuing offers, potential sources of income * * * through sale or the exercise of the rights." (302 U. S., at p. 71).

**I. This Court's affirmance of the Tax Court's decision was based on an erroneous understanding of the facts.**

**(a) Short Restatement of the Facts.**

The respondent was employed by the Western Cooperage Company (hereinafter called Western). Western, under a reorganization plan of the Hawley Pulp and Paper Company (hereinafter called Hawley) was to have the right to receive certain shares of Hawley stock. In December, 1934, Western gave an option to the respondent to purchase, on or before January 1, 1940, at a price of $7,437.70 "the right to receive" 74,377 shares of Hawley (R. 25). The option price was accordingly 10¢ a share. At the time the option was given the market value of Hawley stock did not exceed 10¢ a share (R. 28).

The option was given to the respondent "in consideration of services rendered" by the respondent prior to December 10, 1934 (R. 25). It was completely assignable, and could pass by will or by intestacy.

In March, 1938, the respondent exercised his option *in its entirety* and on March 21, 1938, paid Western $7,437.70 for 74,377 shares of Hawley (R. 27, 19, 20). Western did not have possession of the Hawley stock and delivery was made to the respondent from the depositary under the re-

organization plan of Hawley pursuant to direction of Western (R. 28, 143).

Western in its 1938 income tax return reported $7,437.70 as a capital gain with the explanation "Sale of our right to receive 74,377 Shares Common Stock of Hawley Pulp and Paper Company" (R. 28).

The depositary under the reorganization plan delivered 33,759 shares of Hawley to the respondent on March 19, 1938, and delivered an additional 12,374 Hawley shares to the respondent at various dates in 1939 (R. 28).

In March, 1938, at the time the option was exercised in its entirety and the first 33,759 shares delivered pursuant thereto, the stock of Hawley had a fair market value of $2.50 per share (R. 29).

The 12,374 shares delivered to the respondent in 1939 had an aggregate fair market value of $72,709.38 at the dates of their delivery, or an average fair market value per share of about $5.90 (R. 29).

The decision of the Tax Court as to the amount of the income tax deficiency (as opposed to its opinion) measured the compensation with respect to the 33,759 shares delivered in 1938 as the difference between 10¢ and $2.50 per share, but measured the compensation with respect to the 12,374 shares delivered in 1939 as the difference between 10¢ and approximately $5.90 a share.

**(b) The Misunderstanding of this Court as to the Date of Exercise of the Option.**

The Tax Court stated in its opinion that the petitioner received compensation when he *exercised* his option and Western parted with the right to receive stock which had a much greater value than the option price. The Tax Court states:

> "When petitioner [respondent here] exercised his option and received the stock, Western parted with the right to receive stock which had a much greater value than the option price. Under the reasoning of the *Connolly* case, petitioner received compensation to the extent of the differential" (R. 33).

This Court said that the Tax Court found

> "implicitly that the compensation referred to was the excess in value of the shares of stock over the option price whenever the option was exercised."

This Court also said that

> "the compensation [was] to be derived from exercise of the option after the anticipated advance in the market price of the stock."

Accordingly, the theory of the above quoted portions of the opinions is that the respondent's compensation is measured by the difference between the value of the stock when Western parted with the right to receive it, and the option price. However, Western transferred the right to receive the Hawley stock to the respondent in March, 1938, when he exercised his option in its entirety and paid for all of such stock (R. 27, 19, 20). The option was to purchase from Western the "right to receive" the Hawley stock. That was all done in 1938 (R. 148). The fair market value of the Hawley stock at that time was found to be $2.50 per share. Accordingly, the compensation derived from the option with respect to the 46,133 shares of Hawley delivered to the petitioner by the depositary in 1938 and 1939 could not have exceeded $115,332.50 [46,133 x $2.50], less $4,613.30, the amount paid therefor. However, the deficiency found by the Tax Court (which was affirmed by this Court) is based upon aggregate compensation for 1938

and 1939 of $152,682.58, less $4,613.30, which takes into account the rise in the value of the Hawley shares after Western had completely parted with its right to receive such shares on the exercise of the option in March, 1938.

This Court states, however:

> "In two later tax years, when the market value of the stock was greater than the option price, respondent exercised the option, purchasing large amounts of the stock in each year."

And again:

> "In that [1938] and the following year respondent, by the exercise of his option, acquired from Western large amounts of the stock on payment of the option price."

As such an assumption of the facts would be the only possible way in which the Tax Court's decision could be made in any way consistent with the theory of the opinions, it is not surprising that this Court thought the facts were as it had stated them. However, as pointed out above, it is clear that the respondent exercised his option in 1938 and paid for all the stock in 1938 (R. 27, 19, 20). There was no longer any option after that date. After the exercise of the option and the payment for the stock in March, 1938, Western had no further interest in the transaction. Deliveries were made not by Western but by the depositary under the reorganization plan of Hawley.

This Court indicated that (assuming that the option had no value when received, which assumption we challenge) "the compensation referred to was the excess in value of the shares of stock over the option price whenever the option was exercised". If that be the true rule, since

the value of the Hawley stock was only $2.50 a share when the option was exercised, the *decision* (as opposed to the opinion) of the Tax Court, which includes as compensation a much greater amount, cannot properly be affirmed by this Court.*

**(c) The Misunderstanding of this Court with Respect to the Value of the Option when Given.**

The opinion and the findings of fact of the Tax Court state that it was the *option* which was given as compensation for services. The Tax Court said (R. 33):

> "It is indisputable that Western gave the option to petitioner [respondent here] as compensation for services rendered in effecting the reorganization plan of Hawley."

No finding was made by the Tax Court with respect to the value of that option. Accordingly, the Tax Court failed to make a finding on what this Court's opinion considers to be a most material fact. If the option was given as compensation (as the Tax Court found) the fair market value of the option when received would measure that compensation. The Treasury Regulations so provide:

> "If services are paid for with something other than money, the fair market value of the thing taken in payment is the amount to be included as income." (Treasury Regulations 101, Article 22(a)-3).

This Court appears to have noted in its opinion the inconsistency between the Tax Court's finding that it was the

*Assuming that the respondent was on the cash basis (as almost all individuals are) questions as to the proper year of the taxation of the difference between 10¢ and $2.50 per share would be briefed on the reargument.

option itself which was given as compensation and its opinion (as construed by this Court) to the effect that the compensation was derived "from exercise of the option after the anticipated advance in market price of the stock." This Court points out that an option may be considered to be "property" in the hands of the option holder, citing its own decisions to that effect.*

However, this Court assumes that the option had no value when received, an assumption which appears to be negatived by the very fact that it was given as compensation. Corporations are not presumed to give valueless property as compensation.

Moreover, this Court, we submit, was under the misapprehension that a long-term option to purchase stock at or above the market price of the stock when the option is given has no value. That is not so. It is clear that a long-term option (in the instant case, for over five years) to purchase at the market when the option is given does have a value, as is shown by the list of quotations of options to purchase at *more* than present market value which is contained in Appendix A to this memorandum.

A failure by the Tax Court to make a finding as to whether the option had value should not be considered by this Court as a finding that the option had no value, particularly where it is apparent that such an option does have value.

This Court's decision in *Palmer* v. *Commissioner*, 302 U. S. 63, has generally been regarded as a holding that

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*That an option to purchase stock is property is also supported both by Treasury Ruling and by Congressional Committee Reports. See G. C. M. 23677, 1943 C. B. 370, and the report of the Committee on Ways and Means with respect to the Revenue Bill of 1942, Report No. 2333 (77th Cong., 2nd Sess.) p. 98.

income may not be realized from the mere receipt of an option granted at the current market price of the stock. If this Court intends to overrule that aspect of the *Palmer* case, an opportunity should be given to the respondent to present evidence as to the value of the option when received, in order that the Tax Court may make a finding with respect to a point which was apparently not considered material at the time of the hearing.

**II. This Court should clarify the extent to which its decision in this case overrules its decision in Palmer v. Commissioner.**

The Treasury Regulations have for many years treated as analogous situations cases where a corporation sells property or gives options to its shareholders and cases where it sells property or gives options to its employees. The instant case deals with the latter situation. *Palmer* v. *Commissioner*, 302 U. S. 63, dealt with the former.

The *Palmer* case arose under the Revenue Act of 1928. At that time Treasury Regulations 74, issued under the Revenue Act of 1928, contained the following sentence in Article 51:

> "Where property is sold by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value, such shareholder of the corporation or such employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value."

The *Palmer* case involved options to purchase stock of The United Corporation (hereinafter called United) which was owned by The American Superpower Company (here-

inafter called Superpower). In 1929, Superpower gave its shareholders options to purchase United stock at $25 a share. Such options (called "rights") were received by the shareholders about January 31 and had to be exercised by February 15. It was found by the Tax Court (then the Board of Tax Appeals) that on the day the options were given the fair market value of United stock was $25 a share. However, rights to purchase United stock (each right authorizing the purchase of one-half share) sold at that time for approximately $12 apiece, so that the right to purchase a full share of United at $25 a share was in itself worth approximately $24.

The taxpayer in the *Palmer* case was a shareholder of Superpower who received options to purchase United stock. The Commissioner of Internal Revenue ruled that such options were dividends and assessed a deficiency against the shareholder based on the market value of the options when the shareholders were first entitled to exercise them.

This Court, however, stated that the rights

> "are at most options or continuing offers, potential sources of income to the stockholders through sale or the exercise of the rights. Taxable income might result from their sale, but distribution of the corporate property could take place only on their exercise" (302 U. S. at p. 71).

This Court then went on to hold that the shareholder realized no income upon the exercise of the option even though the United stock was worth more than $25 a share when the option was exercised, saying:

> "Second. We think that a distribution of assets by a corporation to its stockholders by means of a sale, to which it is committed by appropriate corporate action at a time when their sale price represents

> their reasonable value, is not converted into a dividend by the mere circumstance that later, at the time of their delivery to stockholders, they have a higher value. * * * It is a solecism to speak of a corporation as distributing its profits for the sole reason that, after it has unavoidably assumed that risk [that the property may increase in value] in order to effect a sale of its property to stockholders at a fair price, the property increases in value. * * * In every case purchasers may, as a result of market change, acquire property at less than its value at the date of acquisition. But in the case of the corporation it does not follow that there has been a distribution of its profits. It can hardly be said that profits accrue to a corporation from a fortuitous gain in market value, the benefits of which it has relinquished before the gain occurs." (302 U. S. at pp. 71-73).

Applying the above language to the analogous situation where an option is given to an employee rather than to a shareholder, it would appear:

1. That the mere receipt of an option to purchase property at current market does not result in the realization of income, unless it was intended as a distribution from the corporation to the employee.

2. That, if when the option is given the option price is not less than the market price, there has been no distribution by the corporation upon the exercise of the option even though when the option is exercised the market price is greater than the option price. This is because a corporation cannot be deemed to distribute an appreciation in value which it has contracted away before that appreciation occurred. Accordingly, if the appreciation in value is not deemed to be a distribution from the corporation [the

employer] it is difficult to see how it can be deemed to be compensation to the employee.

**Difficulties Resulting from a Complete Abandonment of the Palmer Rule.**

As is pointed out above, the option in the instant case and the option in the *Palmer* case both had a value when received. The *Palmer* case holds that neither the receipt of such an option nor its exercise results in the realization of income. The opinion in the instant case indicates, although it does not decide, that the receipt of such an option may result in the realization of income, if the option has a value when received, and is given as compensation. That seems logical and correct.

However, when the option has no value when received (a situation which in practice is most unlikely to arise), this Court apparently believes that later accretions in value received by the employee pursuant to the option are the measure of the compensation.

Once this Court lays down the principle that, if property be given as compensation, the employee may be taxed not only on the value of the property at the time it is received but on all later accretions thereto which are deemed also to be intended as compensation, it has created possibilities for great confusion.

Suppose, for example, that a corporation gives its employee as compensation some stock which is worth 1¢ a share but which it is hoped will appreciate in value. Is it open to the Commissioner to tax the accretions in value to that stock each year as compensation to the employee on the ground that his employer intended such accretions to be compensation? That same problem arises on a sale of the stock. Can such a sale be the receipt of compensation?

Would the problem be different if the stock were worth $100 per share when received by the employee as compensation?

How can an employer pay compensation out of an accretion in value to which it never had any right? In the case of a completely assignable option, as in the instant case, the decision as to who is to receive the accretion in value rests wholly in the hands of the employee after the option is given. It is up to him to decide whether he wishes to keep the option or to sell it and with it the right to receive the appreciated stock. Certainly, if the employee sells the option to an outsider in an arm's length transaction, and that third party exercises the option, the corporation cannot be said to have paid any compensation at the time the option is exercised. Moreover, the amount which the employee receives for the option upon his sale to a third party would not necessarily correspond in any way with the value of the stock at the time (perhaps years later) when the third party exercises the option and the corporation gives such third party the right to receive the stock.

Similar difficulties would occur where the employee dies and the option is later exercised by a third party, a transferee of his estate.

The answer to the above questions appears to us to lie in the well-reasoned opinion of the Chief Justice in the *Palmer* case, in which this Court very clearly sets forth that accretions in value of property after an option to sell it has been given by a corporation cannot be distributions by the corporation, on the logical ground that the corporation lost its interest in such accretions by giving the option.

To take the instant case as an example, Western lost all interest in any accretion over 10¢ a share in 74 377 shares of Hawley when it gave the option at that price to the re-

spondent in December, 1934. That option had a value, and it would appear to be proper to distinguish the *Palmer* case to the extent of holding that compensation was given to the respondent in the amount of that value.

It appears to us to be wholly incorrect to say that Western paid any compensation to the respondent when the option was exercised in March, 1938. Western had had no interest in the accretion in value on those 74,377 shares since December, 1934.

Moreover, it is completely illogical to go beyond the date of the exercise of the option and permit the respondent to be taxed on increases in value after he had exercised the option and paid for the stock. We believe that this Court did not intend so to hold, and its opinion appears to say that the exercise of the option is the controlling date. All the respondent was entitled to under the option was the "right to receive" the Hawley stock. That he got in its entirety in 1938 upon the exercise of the option and complete payment thereunder. After that the option was gone.

It is respectfully submitted that this Court should grant a rehearing and set a date for reargument, in order that the inconsistency between the decision of the Tax Court (which this Court affirmed) and the opinions both of this Court and of the Tax Court may be corrected.

Respectfully submitted,

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March 20, 1945.

## APPENDIX A

### Quotations of Stock Option Warrants to Purchase Stock at More than Market*

A. C. F.-Brill Motors Company

Warrant to purchase 1 share of common at $12.50 to 1/1/50 and at $15.00 to 1/1/55

| | | |
|---|---|---|
| New York Times 3/18/45 | common | 11⅝ |
| | warrant | 5¼ |

American & Foreign Power Co. Inc.

Warrant to purchase common at $25 per share unlimited

| | | |
|---|---|---|
| New York Times 3/18/45 | common | 3⅝ |
| | warrant | 7/16 |

Atlas Corporation

Warrant to purchase common at $25 per share unlimited

| | | |
|---|---|---|
| New York Times 3/18/45 | common | 16⅜ |
| | warrant | 2⅞ |

Baldwin Locomotive Works

Warrant to purchase common at $15 per share to 9/1/45

| | | |
|---|---|---|
| The Commercial and Financial Chronicle 2/17/42 | common | 13⅜ |
| | warrant | 3½ |

Colorado Fuel & Iron Corp.

Warrant to purchase common at $35 per share to 2/1/50

| | | |
|---|---|---|
| New York Times 3/18/45 | common | 27¼ |
| | warrant | 6⅛ |

Commonwealth & Southern Corporation

Warrant to purchase common at $30 per share unlimited

| | | |
|---|---|---|
| Wall Street Journal 3/8/45 | common | ⅞ |
| | warrant | 1/16 |

Electric Power & Light Corporation

Warrant to purchase common at $25 per share unlimited

| | | |
|---|---|---|
| Wall Street Journal 3/8/45 | common | 5 |
| | warrant | 11/16 |

Manati Sugar Company

Warrant to purchase common at $12.50 per share to 11/5/47

| | | |
|---|---|---|
| Wall Street Journal 3/8/45 | common | 10 |
| | warrant | 2⅝ |

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*The terms of the warrants are taken from Moody's Manual of Investments—1944, except for the A. C. F.-Brill Motor Company warrants, the terms of which have been taken from Sinclair-Murray, Capital Changes Service.

MERRITT-CHAPMAN & SCOTT CORPORATION

Warrant to purchase common at $30 per share unlimited
The Commercial and Financial Chronicle 1/27/42 common 5½
warrant ½

NEW YORK CITY OMNIBUS CORPORATION

Warrant to purchase 2½ common at $17.50 per share to 3/1/47
The Commercial and Financial Chronicle 1/27/42 common 13½
warrant 2⅝

RADIO-KEITH ORPHEUM CORPORATION

Warrant to purchase common at $15 per share to 1/31/50
New York Times 3/18/45 common 8½
warrant 1½

RICHFIELD OIL CORPORATION

Warrant to purchase common at $20 per share to 3/14/47
Wall Street Journal 3/8/45 common 13½
warrant 1⅜

TRI-CONTINENTAL CORPORATION

Warrant to purchase 1.22 common at $18.46 a share unlimited
Wall Street Journal 3/2/45 common 6⅞
warrant 1⅞

UNITED CORPORATION

Warrant to purchase common at $27.50 per share, unlimited
Wall Street Journal 3/8/45 common 1¾
warrant ⅛

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